



STATE BOARD OF EQUALIZATION STAFF LEGISLATIVE BILL ANALYSIS

Date Amended:	4/29/02	Bill No:	AB 2662
Tax:	Property	Author:	Bogh
Board Position:		Related Bills:	

BILL SUMMARY

This bill would:

1. Allow a single member limited liability company organized and operated for charitable purposes, as specified, to qualify for the welfare exemption, and
2. Specify that property in the course of construction will not be considered “abandoned,” and therefore no longer eligible for exemption, in certain instances where bonds will be issued to obtain tax-exempt financing.

ANALYSIS

Current Law

Revenue and Taxation Code Section 214 provides for a “welfare exemption” under which property is exempt from property taxation if it is used exclusively for religious, hospital, scientific, or charitable purposes, and it is owned and operated by funds, foundations, or corporations meeting numerous statutory requirements.

Single Member Limited Liability Companies. Under current law, property owned by a single member limited liability company (hereinafter Single Member LLC) organized and operated for charitable purposes does not qualify for the welfare exemption provided in Section 214 of the Revenue and Taxation Code. As set forth below, the Single Member LLC is not a qualifying entity under Section 214, nor is there any legal authority that allows the Single Member LLC’s status as an entity separate from its owner (a nonprofit corporation exempt under federal and state income tax law) to be disregarded for purposes of qualifying for the welfare exemption. Accordingly, under existing law property owned and operated by a Single Member LLC could not qualify for the welfare exemption.

Property in Course of Construction – Delays. Under current law, Section 214.1 provides that a welfare exemption is available to properties in the “course of construction.” Section 214.1 is authorized by Section 5 of Article XIII of the California Constitution. This provision was enacted in recognition of the fact that the welfare exemption authorized under Section 4(b) of the Constitution does not apply to vacant, unused property held for future qualifying use. Section 5 extends the exemption to buildings under construction, land required for their convenient use, and equipment in them if the intended use would qualify the property for exemption.

Section 5 is implemented by Sections 214.1 and 214.2. Section 214.1 defines property used exclusively for religious, hospital or charitable purposes to include facilities in the

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course of construction, together with the land on which the facilities are located as may be required for their convenient use and occupation. Section 214.2 states that as used in Section 214.1 "facilities in the course of construction" includes the demolition or razing of a building with the intent to replace the building with a facility to be used exclusively for religious, hospital or charitable purposes. "Facilities in the course of construction" must have activity connected with the construction or rehabilitation of a new or existing building or improvement that results in physical changes visible to any person inspecting the site where the building or improvement is located. The phrase, "in the course of construction," as used in Section 214.1 has been construed to include the digging of trenches for the foundation of a building prior to the lien date.¹

If construction delays are due to reasonable causes and circumstances beyond the assessee's control, that occur notwithstanding the exercise of ordinary care and the absence of willful neglect, then construction shall not be considered "abandoned." (However, under existing assessment practices, delays due to "a lack of funds" by the claimant would not be considered reasonable). Unless abandoned, a property undergoing normal construction or rehabilitation activity for an extended period of time would be exempt.

Proposed Law

Single Member Limited Liability Companies. This bill would add subdivision (k) to Section 214 to provide that property used exclusively for religious, hospital, scientific, or charitable purposes and owned and operated by a limited liability company having a single member religious, hospital, scientific, or charitable fund, foundation, or corporation, which property and fund, foundation, or corporation meet all the requirements of subdivision (a) of Section 214 may qualify for the welfare exemption.

Property in Course of Construction – Delays – Tax-Exempt Financing. This bill would amend Section 214.1 to specifically provide that property in the course of construction, (i.e., construction has commenced but not yet finished) is not "abandoned," if the construction or rehabilitation is financed or reimbursed, in whole or in part, from the proceeds of tax-exempt financing where:

- The construction or rehabilitation commences not later than 180 days following the date the issuer of the bonds to be issued in connection with the tax-exempt financing, by resolution or in any other reasonable form, declares its official intent to initiate the process for the issuance of the bonds to be issued in connection with the tax-exempt financing, and
- The construction or rehabilitation is substantially completed not later than 36 months following this date.

In General

Welfare Exemption. Under Section 4(b) of Article XIII of the California Constitution, the Legislature has the authority to exempt property (1) used exclusively for religious, hospital, or charitable purposes, and (2) owned or held in trust by nonprofit organizations operating for those purposes. This exemption from property taxation,

¹ *National Charity League v. County of Los Angeles* (1958) 164 Cal.App.2d 241.

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popularly known as the *welfare exemption*, was first adopted by voters as a Constitutional Amendment on November 7, 1944. With this amendment, California became the last of 48 states in the country to provide such an exemption from property taxes. The ballot language in favor of the amendment stated:

These nonprofit organizations assist the people by providing important health, citizenship and welfare services. They are financed in whole or in part by your contributions either directly or through a Community Chest. It is good public policy to encourage such private agencies by exemption rather than to continue to penalize and discourage them by heavy taxation.

When the Legislature enacted Section 214 of the Revenue and Taxation Code to implement the Constitutional provision in 1945, a fourth purpose, *scientific*, was added to the three mentioned in the Constitution. Section 214 parallels and expands upon the Constitutional provision by exempting property used exclusively for the stated purposes (religious, hospital, scientific, or charitable), owned by qualifying nonprofit organizations if certain requirements are met. An organization's *primary* purpose must be either religious, hospital, scientific, or charitable. Whether its operations are for one of these purposes is determined by its activities. A qualifying organization's property may be exempted fully or partially from property taxes, depending on how much of the property is used for qualifying purposes and activities. Section 214 is the primary welfare exemption statute in a statutory scheme that consists of more than 20 additional provisions. Over the years, the scope of the welfare exemption has been expanded by both legislation and numerous judicial decisions.

Owned and Operated Requirement. Section 214 requires that, to be eligible for the welfare exemption, both the owner and the user of a property must meet specific requirements. The first step in determining welfare exemption eligibility is to determine if the organization itself qualifies. In brief, an organization must meet the following requirements:

- It must be organized and operated for exempt purposes;
- It must not be organized or operated for profit;
- The owner organization must have an IRC §501(c)(3) or Revenue and Taxation Code 23701d letter of exemption;
- The user organization may also qualify with an IRC §501(c)(4) or Revenue and Taxation Code §23701f or §23701w letter;
- The organization's earnings must not benefit any private shareholder or individual;
- Articles of Incorporation must contain an acceptable statement of irrevocable dedication of the property to exempt purposes;
- Articles must contain an acceptable Dissolution Clause; and
- The property owner must be the owner of record on the lien date.

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Where there are different owners and operators, property is not eligible for exemption unless the **owner and operator** meet the specific requirements of Section 214. An operator is a user of the property on a regular basis, with or without a lease agreement. Typically, the owner and operator are one and the same and the filing of one claim for exemption will suffice. However, it is not necessary that the owner and the operator of the property be the same legal entity. If property is owned by one exempt organization and operated by another exempt organization, each must qualify and file a claim for exemption. If the operator is not an exempt organization, the welfare exemption is not available on the property.

Specific Requirements for Use of Property. The Constitution and statutes impose a number of requirements that must be met before property can become eligible for exemption. Nonprofit organizations claiming exemption for their properties must satisfy various organizational requirements and must meet additional requirements that govern the uses of their property. With respect to the use of the property:

- The property must be used exclusively for exempt purposes.
- The property must be used for the actual operation of an exempt activity.²
- The property is not to be used to benefit any person through distribution of profits, compensation or the more advantageous pursuit of his or her business or profession.

Background

Qualification of a Separate Member LLC for the Welfare Exemption. The welfare exemption is created by Article XIII, Section 4, which authorizes the Legislature to exempt property used exclusively for religious, hospital, or charitable purposes and owned or held in trust by corporations or other entities. In implementing this provision, the Legislature has specified that the “other entities” are to be “community chests, funds (or) foundations.” An LLC is not one of those entities.

It is generally recognized that only three entities can be used for nonprofit organizations (See CEB, Advising Nonprofit Corporations, § 2.2.):

- an unincorporated association,
- a trust, or
- a nonprofit corporation.

The Legislature has set forth requirements for organization of unincorporated associations (Corporations Code §§2100-21401), for nonprofit public benefit corporations (Corp. Code §§5110-6815) and charitable trusts. California's Trust Law (Probate Code §§15000-19403) applies to charitable trusts to the extent that the Trust Law does not conflict with the Supervision of Trustees and Fundraisers for Charitable

² The exemption is limited to the amount of property reasonably necessary for the accomplishment of the exempt purpose. Portions of the property in excess of that reasonably necessary for the purposes of the organization do not meet the requirements for property tax exemption and are subject to taxation.

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Purposes Act (Gov. Code §§12580-12599.5; Probate Code §15004). These are the entities that can qualify for exemption under Section 214.

An LLC can be used to operate a business generating unrelated business income for a nonprofit corporation. (See CEB, *Advising Non-Profit Corporations* §15.57.) Since the Corporations Code authorizes the creation of an LLC solely for business purposes, an LLC cannot satisfy the requirements that the property must be owned by one of the specified entities organized and operating for exempt purposes. (Section 4 of Article 13 of the California Constitution and Section 214.) As such, under existing law, property owned by an LLC cannot qualify for the welfare exemption from property taxes in Section 214.

It is well established that constitutional and statutory provisions granting exemptions from taxation are to be strictly, but reasonably construed. In administering such provisions, the Board and county assessors cannot expand their application beyond the plain language of the sections. (*Cedars of Lebanon Hospital v. County of Los Angeles* (1950) 35 Cal.2d 729, 734.)

Federal and State Treatment of Single Member Limited Liability Companies For Income Tax Purposes - Disregarded Entity. As of January 1, 2000, the Corporations Code has allowed entities to organize as single member limited liability companies. (Corp. Code §§17001, subd. (t); 17050, subd. (d).) Under both state and federal income tax law, a Single Member LLC is treated as an entity that is not separate from its owner and is disregarded for income tax purposes, unless the Single Member LLC elects to be classified as a corporation. (Rev. & Tax. Code §23038; Treas. Reg. Section 301.7701-3(b); Cal. Corp. Code §17254.) As such, a disregarded entity is treated as if it doesn't exist and its assets are treated as being owned directly by its Parent, a sole member nonprofit corporation.

However, the same does not apply to property taxes since the Corporations Code recognizes a limited liability company as a separate legal entity,³ and there is currently no statutory or regulatory authority for disregarding that separate entity for property tax purposes. The Legislature has conformed franchise tax filing requirements for Single Member LLC's to federal law, but it has not made a similar provision for property tax. As such, property owned by a Single Member LLC would not qualify for exemption under Section 214, for the reasons discussed above, nor would the Board disregard the Single Member LLC's ownership of its property so that the property could qualify for exemption as property of the Parent (nonprofit) corporation.

COMMENTS

- 1. Sponsor and Purpose.** This bill is sponsored by the author to ensure a property tax exemption for property otherwise eligible for the welfare exemption except for its form of ownership. Additionally, it would address the case where the process of obtaining tax exempt financing delays construction in progress.

³ See California Corporations Code section 17000 et. seq which authorizes the creation of LLCs as a recognized entity for businesses in California.

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2. **Amendments.** The April 29 amendments would extend the provisions of the bill to any property used for religious, hospital, scientific, or charitable purposes and owned and operated by a single member LLC where the single member is a religious, hospital, scientific, or charitable organization and both the particular property and the particular organization meet all the requirements for the welfare exemption. As introduced, the bill applied only to property used for “health-care” purposes, as specified. Additionally, the amendments limit the conditions where “construction in progress” will not be considered “abandoned.” As introduced, those conditions could have been broadly interpreted.
3. **Various nonprofit organizations have approached the Board of Equalization investigating the possibility of reforming as single member LLC’s.** Although we appreciate the liability concerns of nonprofit organizations that seek to shield existing assets while acquiring additional real property, we have responded to those inquiring that existing law does not permit this and that only the Legislature has the authority to change the laws to make the welfare exemption available to property owned by single member LLCs.
4. **California does not provide for the formation of nonprofit LLCs; therefore, it is recommended that, in addition to amending property tax law, the Corporations Code be amended to allow for the formation of nonprofit LLCs.** While an organization that qualifies as a tax-exempt organization under 501(c)(3) of the Internal Revenue Code can legally form a single member LLC, there is nothing in the law that specifies that the organization must operate the LLC in a not for profit manner. The Legislature has not amended the Corporations Code (specifically the Beverly-Killea Limited Liability Company Act, Corp Code Sections 17000 et seq.) to authorize the formation of nonprofit LLCs. Many states allow a LLC to be formed for any lawful purpose, but California requires that a LLC be formed for a **business** purpose. Subject to any limitations contained in the LLC's articles of organization and other applicable laws, a limited liability company may engage in any lawful business activity, with specified exceptions, and shall have all the powers of a natural person in carrying out its business activities. (Corp. Code §§ 17002 and 17003.) The Corporations Code does not authorize the formation of an LLC for a nonprofit, exempt (hospital, religious, charitable, or scientific) purpose. In our view, it would be also necessary to amend the Corporations Code to add provisions that allow the formation of an LLC as a nonprofit organization, similar to existing provisions that authorize the formation of corporations organized and operated for nonprofit purposes. (See Nonprofit Public Benefit Corporation Law, sections 5110-6815, added by Stats. 1978, c. 567, operative January 1, 1980.)
5. **Additionally, the Secretary of State does not recognize "nonprofit LLCs" since that office follows the corporate and nonprofit statutes quite strictly.** If an organization attempts to file as a nonprofit LLC, the Secretary of State registers it either as a domestic or foreign (out of state) LLC, both for-profit.

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- 6. Under existing law and assessment practices a relatively minor preparatory activity such as grading vacant land as soon as it is acquired or tearing down a building, can be undertaken for the purpose of commencing the property tax exemption.** Currently, Assessors' Handbook 267 "Welfare, Church, and Religious Exemptions," gives examples of construction delays due to reasonable causes and circumstances beyond the assessee's control, as (1) adverse weather conditions or (2) material shortages. Delays due to a lack of funds is used as an example that is not considered reasonable. Vacant, unused property that is held for future qualifying use is not eligible for the welfare exemption. Therefore, it is possible that a relatively minor activity, such as digging a trench for a foundation, could start the exemption, with a long term delay before substantive construction takes place on the property.

COST ESTIMATE

The Board would incur some minor absorbable costs in informing and advising County Assessors, the public, and staff of the change in law.

REVENUE ESTIMATE

Background, Methodology, and Assumptions

We are aware of one multi-phase project currently under construction in Riverside County which has applied for the welfare exemption. The claim has been denied, in part, because the form of ownership is a single member LLC. According to the Riverside County Assessor's Office, the total assessed value of the property is estimated to be \$13.5 million upon completion. The annual revenue impact from exempting the property from the basic one percent tax rate would then be \$135,000 (\$13.5 million x .01). However, the facts of each case are critical in determining whether the welfare exemption will be available to a particular property or organization. Although it is clear that this property would not be exempt under the welfare exemption without this bill because of the form of ownership, it is possible that there may be other conditions that would prevent this project from qualifying for the welfare exemption in any case.

Revenue Summary

The annual revenue impact at the basic one percent property tax rate if the property in Riverside County is exempt under the welfare exemption would result in a revenue loss of \$135,000.

In addition, in the last two or three years, several other claims for the welfare exemption have been denied because the properties in each case were owned and operated by a limited liability company. In some of these cases, the nonprofit corporation owner may have decided to change the form of ownership to one that would be eligible to receive the welfare exemption.

Staff estimates that there may be 10 or 20 existing projects throughout the state that would be eligible for the welfare exemption under this proposal. Assuming that each of these has a value in the neighborhood of \$10 million, the estimated total assessed

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value of these properties is [10 to 20 projects] x \$10 million per project, or \$100 million to \$200 million. The estimated annual revenue impact at the basic one percent tax rate for these projects is \$1 million to \$2 million, [\$100 million to \$200 million x 1%.]

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